



February 17, 2009

AGENDA ITEM 3

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Policy Subcommittee Report
- II. PROGRAM:** Total Fund
- III. RECOMMENDATION**
- a. Total Fund - Adoption of Policy on Divestment
 - b. Global Fixed Income – Revision of Policy on Global Fixed Income Program
 - c. Global Equity
 - 1) Revision of Policy on Internally Managed Global Equity Index Funds
 - 2) Revision of Global Principles of Accountable Corporate Governance
 - d. Supplemental Income Plans – Revision of Policy on Supplemental Income Plans
 - e. Policy Review and Consolidation Project – Revision of Ethics Policies
 - 1) Revision of Policy on Insider Trading
 - 2) Revision of Policy on Consultant Conflict of Interest
 - f. Policy Review and Consolidation Project – Revision of Shareowner Activities Policies
 - 1) Revision of Policy on Corporate Governance Director Nominations
 - 2) Revision of Policy on Representation on Corporate Boards of Directors
 - 3) Revision of Policy on Economically Targeted Investment Program

IV. ANALYSIS:

Background

The Policy Subcommittee met on December 15, 2008. The Subcommittee reviewed proposed revisions to several policy categories, including Total Fund, Global Fixed Income, Global Equity, Supplemental Income Plans, Real Estate, Ethics and Shareowner Activities policies.

The revised Policies are attached. Unless otherwise noted, the revised Policies are presented as black-lined versions from the last adopted policy by the Investment Committee. The black-line uses strike-out to indicate deletions and double underline to indicate additions. Single underline does not indicate a change; rather it indicates that the term is defined in the glossary.

Each of the recommended policy revisions are explained below.

Adoption of Policy on Divestment

Staff recommended that the Subcommittee adopt a policy that requires CalPERS to divest or underweight an investment to the extent CalPERS concludes that continued ownership of the investment is no longer prudent, or, in the case of a new investment, would be imprudent. Staff also recommended including a statement that CalPERS generally favors an approach of constructive engagement rather than divestment.

The Subcommittee recommends adoption of the Divestment Policy.

Revision of Policy on Global Fixed Income Program

Staff recently reported the use of Credit Linked Note (CLN) securities within the domestic fixed income portfolio. While CLNs were already allowed under the Statement of Investment Policy for Global Fixed Income, Wilshire recommended and Staff agreed that the Permitted Opportunistic Investments Section (Attachment A, IV.C.4.) should be updated to include CLNs as specifically permitted investments.

Staff also noted the absence of definitions for collateralized debt obligations (CDO), collateralized loan obligations (CLO), and credit linked notes (CLN). Definitions for CDO, CLO, and CLN have been added to the glossary.

The Subcommittee recommends approval of the revised Global Fixed Income Program policy.

Revision of Policy on Internally Managed Global Equity Index Funds

Staff recommended two changes to the Internally Managed Global Equity Index Funds policy:

- Emerging Markets Benchmark – Staff recommended removing Argentina from the Emerging Markets benchmark. The Argentine government had proposed legislation to take control of the country’s private pension system. This action was believed to be caused by the country’s inability to service its outstanding debt and was seen as a precursor to a likely default.
- Dynamic Completion Fund (DCF) Structure – Staff recommended expanding the DCF program to incorporate externally and internally managed portfolios and broaden the DCF program to “complete” U.S. domestic equity and international equity exposure.

The Subcommittee recommends approval of the revised statement of Investment Policy for the Internally Managed Global Equity Index Funds policy.

Revision of Global Principles of Accountable Corporate Governance

The table below summarizes staff’s recommended revisions to the Global Principles of Accountable Corporate Governance:

| Market | Identifier | Page | Topic | Principle Amendment |
|---------------|-------------------|-------------|-------------------------------------|--|
| Domestic | B.3.2a | 11 | Performance Link | Adds the language “sustainable long-term” in reference to executive compensation being tied to performance objectives. |
| Domestic | B.3.3a | 12 | Mix of Cash and Equity | Adds language regarding disclosure of executives’ holding and hedging policies related to stock ownership. |
| Domestic | B.3.3b | 12 | Equity Grants Linked to Performance | Removes the word “time” from “time accelerated vesting”, indicating that any form of accelerated vesting is not an acceptable methodology for equity grants. |

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|----------|--------|----|---|--|
| Domestic | B.3.3d | 12 | Recapturing Dividend Equivalent Payouts | Adds language to prohibit voting rights on unvested equity. |
| Domestic | B.4 | 14 | Audit Integrity | Changes the title of this section to "Integrity of Financial Reporting" to more appropriately title this section of the Global Principles. |

Staff also recommended two additional revisions:

- Staff recommended that the United Nations Global Compact's complete set of principles be included as an appendix to the CalPERS Global Principles of Accountable Corporate Governance.
- Staff recommended a new section and corresponding appendix dedicated to the governance of public company joint ventures. Staff believes that a similar level of scrutiny and focus placed on public companies as a whole should be extended to the largest joint ventures of public companies.

The Subcommittee recommends approval of the revised Global Principles of Accountable Corporate Governance.

Revision of Policy on Supplemental Income Plans

Market timing or active trading of the Supplemental Income Plans (SIP) funds is not prohibited under the SIP administrative rules; however, excessive short-term trading can negatively affect other participants in the fund. To date, the SIP funds have experienced some short-term trading by several individual participants. Given the small value of these individuals' trades, the fund losses have been small compared to the overall value of the funds.

Staff recommended establishing a frequent trading policy to achieve a balance between the right of individual participants to exercise control over the assets in their accounts and the right of all participants to enjoy appropriate growth of their assets in proportion to the risk they bear.

The Subcommittee recommends approval of the revised policy on Supplemental Income Plans.

POLICY REVIEW AND CONSOLIDATION PROJECT

The objectives of the Policy Review Project are (1) to organize and streamline Investment Policy to improve access, clarity and transparency, (2) to provide a consistent Investment Policy framework, and (3) to ensure that the policies will facilitate the on-going CalPERS compliance program.

The Policy Review Project entails a detailed review of each policy with the goal of updating and streamlining the policy, as well as potential consolidation with other related policies. In addition to these goals, the review and revisions include the following:

- Removal of delegations from policy. During the Delegations Project, staff reviewed all policies, minutes, and delegations to identify and consolidate delegations. Delegations are now located in consolidated documents.
- Removal of operational and procedural language, which is now located in staff internal procedure manuals.
- Conformance to the new template.

The review is a joint effort and includes input from the General Pension Consultant, the private equity and real estate consultants as appropriate, the CalPERS Legal Office, and the Enterprise Office of Compliance.

A clean version of the Ethics and Shareowner Activity policies are included in this agenda item. A black-line version of the policies were provided in the December 15, 2008 Policy Subcommittee agenda materials.

Revision of Real Estate Policies

Staff presented and the Subcommittee approved the second reading of the Real Estate policy. Subsequent to the December Subcommittee meeting, staff determined that a third reading of the Real Estate policy was needed. The third reading will be presented at the April Policy Subcommittee meeting.

Revision of Ethics Policies

Staff recommended the following changes to the Insider Trading Policy:

- The policy defines “Restricted Person” and it intended to cover all those persons who have access to confidential information.

- The policy emphasizes the importance of Board members and employees avoiding the possession of material, nonpublic information.
- The policy provides clearer guidance on which CalPERS trades can be appropriately exempted from the policy, consistent with federal law, and memorializes exceptions for some trades in transitions accounts.

The Consultant Conflict of Interest policy was edited for clarity and to conform to the new template. No substantive changes were made to the policy.

The Subcommittee recommends revisions to the Insider Trading and Consultant Conflict of Interest policies.

Revision of Shareowner Activity Policies

Staff edited the Corporate Governance Director Nominations policy for clarity and to conform to the new template. Further, Staff also revised the definition for director nominations to explain that we nominate directors to Boards of publicly traded companies.

No substantive changes were made to the Representation on Corporate Boards of Directors policy. The policy was edited for clarity and to conform to the new template.

No substantive changes were made to the Economically Targeted Investment Program policy. Staff removed duplicative language and streamlined the policy to more effectively define ETI and California Emerging Markets. The policy was also edited for clarity and to conform to the new template.

The Subcommittee recommends revisions to the following Shareowner Activity policies: Corporate Governance Director Nominations, Representation on Corporate Boards of Directors, and Economically Targeted Investment Program.

Technical Revision of Policies to Reflect Benchmark Name Change

In mid-September, Barclays Capital Inc. acquired Lehman Brothers' North American investment banking, capital markets, and private investment management businesses. As part of this transaction, Lehman Brothers' indices are now owned by Barclays Capital and have been renamed. The table below lists the Investment policies affected by this name change.

| Policy Name | Previous Benchmark Name | New Benchmark Name |
|---|--|--|
| Global Fixed Income Program | Lehman Brothers Long Liabilities Index | Barclays Capital Long Liabilities Index |
| Lehman Aggregate Program (Will be re-named to Barclays Aggregate Program) | Lehman Brothers Aggregate Index | Barclays Capital Aggregate Index |
| Treasury Inflation Protected Securities | Lehman Brothers TIPS Index | Barclays Capital TIPS Index |
| Inflation-Linked Asset Class, Attachment B: Inflation-Linked Bond Program | 67% Lehman Total U.S. TIPS Index plus 33% Custom Lehman Global Inflation Linked Bond Index ex TIPS, unhedged | 67% Barclays Total U.S. TIPS Index plus 33% Custom Barclays Global Inflation Linked Bond Index ex TIPS, unhedged |
| SIP CalPERS Risk-Based and Target Retirement Date Funds | Lehman Brothers TIPS Index | Barclays Capital TIPS Index |

In addition, Lehman Brothers will be deleted from the Securities Lending Approved Borrower List and from the Eligible Repo Counterparties List in the Low Duration Fixed Income Program policy.

Finally, the following glossary terms will be updated to reflect this name change: Lehman Brother's U.S. Aggregate Index, Lehman Brother's International Fixed Income Index, Lehman Brother's Long Liability, and Reserve Currency Benchmark Country.

V. STRATEGIC PLAN:

This item supports Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

The results of this item will provide CalPERS with enhanced efficiencies and ability to manage the overall portfolio. The revised policies will provide a foundation for compliance, accountability, and transparency.

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